Widening the Net: Co-Brand Credit Card Growth Opportunities

A White Paper

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About the author

David Morris has personally authored numerous in-depth market research reports and helped dozens of companies with strategic market planning and project execution. As Managing Consultant at Kaleidoscope Research Consulting LLC, a full-service marketing research firm, David helps clients create sustainable marketplace advantage through fact-based consumer understanding and insights, with an emphasis on market segmentation, brand positioning and competitive analysis. David has presented his research to audiences small and large, and his commentary has been featured in the Wall Street Journal, BusinessWeek, Time Magazine, and leading trade magazines. Formerly a Research Director at Mintel International, Inc., where he managed syndicated and custom foodservice research (among other responsibilities), David is also a professor at DePaul University, where he teaches market research, critical thinking, and writing courses. David earned his J.D. at Loyola University Chicago and pursued graduate studies in English Literature at Cambridge University.

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INTRODUCTION

With macroeconomic tailwinds helping to make a fiscally healthier consumer, we believe that the ingredients for moderate growth in credit card account and loans outstanding, are now on hand. Co-branded card programs, which relied heavily on tending to, and growing affluent accounts, not only continue to enhance these programs and craft new niches, but can also cast a wider net, capturing new business from the middle class.

Research suggests that retail, entertainment and airline co-branded cards may provide the highest degree of consumer engagement. With rewards now synonymous with co-branded credit card programs, clearly, the question is not whether a card has rewards, but whether the card has the right mix of hard and soft benefits to drive co-brand partner sales in a cost effective manner for partner and issuer. With rewards an already ubiquitous feature of co-branded cards, many prospective cardholders are weighing the degree to which a card provides extra incentives. Moreover, consumers signing up for co-branded cards are not just looking at their rewards features; they are at least as apt to weigh interest rates, spend limits & fees.

Consumers may also respond well to increased rewards transparency. Rational pitches are not for everyone, and clearly not for every card. In light of trends emphasizing greater transparency, Chase's AARP credit card launch resonates well. Meanwhile, airline co-branded cards are increasingly touting rewards programs that promote transparency, flexibility and simplicity. In this regard, Southwest Airlines has set a new bar.

With so many co-brand programs already targeting the affluent, issuers must pick and choose wisely in their quest to reach this demographic. While it's no stranger to affluent co-branding, American Express is nevertheless heavily reliant on airlines. By tapping new partners, Mercedes Benz and Morgan Stanley, it continues to grow its affluent cardholder base, bringing new, high-spending customers into its franchise.

While both co-branded and private label credit cards have faced challenges, the retail segment still contributes a majority of co-branded credit card programs. Here, thanks in part to private label resurgence, interplay between co-branded and private labeled cards has become both more competitive and more sophisticated.

In some cases, private label has taken the upper hand. One need look no further than Target to find some retail card programs relying on the middle class that perform quite well. By no longer opening new Visa-branded credit card accounts, Target is placing additional emphasis on its private label credit card and co-branded debit card to capture customer spend. The REDcard platform drew success from its simplicity and transparency, offering an everyday discount of 5% on all eligible purchases, a key factor making it stand out from other retail credit cards.

But more commonly, retail programs are converting private label accounts to co-branded accounts. In a twist on that route, Macy's allows its private label cardholders to upgrade to its American Express-branded cards. These co-branded credit cards emphasize cache, a tiered card platform, as well as a strong signup discount.

LATEST CREDIT CARD INDUSTRY DEVELOPMENTS

After suffering drastic reductions in accounts outstanding, the credit card industry is rounding an important bend in the road. We envision an industry that casts a wider net for customers and that once again benefits from moderately increasing loans outstanding.

Tailwinds include:

- An improving U.S. macro-economic environment, with 2013 gains noted in housing, consumer confidence, employment, household wealth and consumer credit.

- Consumers increasingly turning to credit cards to make purchases: 2012 card purchase volume increased at top issuers American Express, Discover Financial Services, JPMorgan Chase, Bank of America, Citibank, Capital One (including volume related to its HSBC card portfolio acquisition) and U.S. Bank.

- Improving credit card delinquency rates (although they have some ways to go before matching those registered prior to the recession).

While credit card users are increasingly turning to their cards to spend money, they remain wary of increasing their level of debt: Q1 2013 average credit card debt was down 15% from its Q3 2009 peak.

GOING FORWARD

In the end, all of this bodes well for the credit card industry, pointing to a stronger credit card lending environment that promises:

- Continued increases in card loan volume
- Healthier consumers able to revolve moderately higher amounts of debt
- Financially sound consumers, which translates to more credit card accounts

It may bode especially well for co-branded card programs, which have relied heavily on affluent accounts. And why not?

- Account holders have healthy credit card spending volumes, are an increasing proportion of the U.S. population, have less risky credit profiles, and a tendency to travel internationally, making them very worthy candidates.
- Both American Express and JPMorgan Chase have gained market share during 2008-2012 by enhancing and/or building card programs targeting the affluent.

CO-BRAND OPPORTUNITY

Co-brand issuers can continue to craft niche card programs targeting the affluent and enhancing current programs by experimenting with a more resonant mixture of hard and soft benefits. As confidence in the U.S. economy improves, they can also cast a wider net, capturing new business from the middle class.

Food for thought

It is estimated that for every 100 people using a credit card branded with the American Express, Discover, Visa or MasterCard logo, there are 58 co-brand/affinity card users.

Now that its consumer portfolios have healthier risk profiles and more consumers carry healthier balance sheets, card issuers can more confidently but selectively acquire new accounts.

By holding and growing card programs with better risk profiles, they may also feel more comfortable increasing their risk exposure via features that differentiate co-brand cards from private label cards, such as higher credit lines, cash advances, and balance transfer promotions.

ASSESSING ENGAGEMENT

Across the co-brand and affinity landscape, each industry segment (airline, retail, sports organization) brings something to the mix. The foundation of credit card economics is usage: if consumers don't use the card, industry participants do not make money.

To gauge the degree of engagement, Packaged Facts has created a simple usage ratio. This was done by dividing the percentage of respondents who have used a respective card type in the past 30 days by the percentage of respondents having that card type, and then multiplying by 100.

Retail and airline cards promise stronger engagement?

Within this context, retail, entertainment and airline co-branded cards promise the highest degree of usage:

For every 100 respondents who have a retail store/internet store co-brand card, some 64 used the card in the past 30 days. Compared to many of the other card types listed, this suggests a high degree of cardholder engagement. On the other hand, affinity card usage ratios are lower, which suggests a lower degree of engagement.

The metric is an important one, as it assists in identifying consumers who have a more active relationship with their card. For card issuers, the larger issue involves developing strategies to maintain and build upon that active relationship, which is where usage incentives (rewards and discounts) and "soft" benefits (such as baggage protection and concierge service) play a significant role.

Table 7-19: Co-Brand and Affinity Credit Card Usage Ratio, by Card Type: 2013

Co-brand/affinity credit card type	Usage Ratio
Entertainment organization	64
Retail store/internet store	64
Airline	63
Professional association	60
Hotel/lodging chain	58
Political organization	58
Alumni/educational organization	55
Sports organization	53
Charitable organization	49
Religious organization	41

Note: usage ratio is created by dividing the percentage of respondents who have used the respective card type in the past 30 days by the percentage of respondents having that card type, and then multiplying by 100. This ratio can provide guidance on the degree of cardholder engagement with each co-brand/affinity card type.

Source: Packaged Facts, based on March 2013 proprietary consumer research results

Base: 840 respondents age 18+ who have a co-brand/affinity credit card

ROLE OF REWARDS

Rewards are synonymous with co-branded credit card programs: every single co-branded card tallied as part of our market segmentation has a rewards program.

For the industry, clearly, the question is not whether the card has rewards, but rather whether the card has the right mix of hard benefits (rewards, points and discounts) and soft benefits (such as concierge service or special events access) to drive additional sales for the co-brand partner, while generating revenue and income for the issuer.

Don't overlook features and benefits common to all cards

While rewards provide incentive to help consumers visit the point of sale and pull the trigger on the purchase at the point of sale, consumers signing up for co-branded cards are not just looking at their rewards features or other benefits. In fact, according to proprietary survey results detailed in our July 2013 *Co-Branded and Affinity Credit Cards in the U.S.* report, we found that interest rates, spend limits & fees (agreement with at least one of six statements related to these topics) were an important consideration in 74% of co-brand/affinity card users' decisions to choose their last co-brand/affinity card.

> **"Thinking back on the last partner/sponsor credit card you applied for, were any of the following considerations important to choosing that card?: Interest rates, spend limits & fees."**

Giving something extra

But with rewards an already ubiquitous feature of co-branded cards, many cardholders may be weighing the degree to which the card provide extra rewards incentives more heavily.

Of course, hard and soft benefits are important, too. But more so than rewards, co-brand/affinity card users are more likely to weigh "extra points" of some kind: Extra points, in aggregate, were an important consideration in 65% of co-brand/affinity card users' decisions to choose their last co-brand/affinity card, followed by rewards (59%) and discounts (47%).

Target the middle class

According to our proprietary survey results, generally speaking, rewards features are most likely to appeal to $75-$99.9K household income consumers, who are also most likely to consider cash back rewards as important. However, $50-$74.9K household income consumers are most likely to find miles rewards and rewards points flexibility as important. This suggests room to develop non-affluent rewards-driven co-branded programs.

A rational pitch

Rational pitches are not for everyone, and clearly not for every card. But in light of trends emphasizing greater transparency, Chase's AARP credit card launch resonates well.

In July 2013, Chase announced a new credit card for AARP members, offering cardholders 3 percent cash back on gas station and restaurant purchases, with no earning caps or points expiration and no annual fee. The card also offers unlimited 1 percent cash back on all other purchases.

As part of its PR release, Chase provides a very rational explanation for the chosen rewards structure, noting that the average household spends nearly $3,000 annually at gas stations, more than $2,600 at restaurants and more than $8,000 on other everyday purchases like groceries, apparel and entertainment. It concludes by noting that its rewards allow the average family to earn more than $250 cash back every year by using the card.

AIRLINE REWARDS TRANSPARENCY, FLEXIBILITY AND SIMPLICITY CASE STUDY: SOUTHWEST AIRLINES

Airline co-branded credit card programs are among the most prized in the industry, due to cardholders' outsized spending volumes and generally lower risk profiles. At American Express alone, we estimate that U.S. airline co-brand card accounts contributed roughly $55 billion to the company's 2012 U.S. consumer, small business, and corporate card purchase volume.

A saturated market

However, the airline vertical is also the most saturated, with virtually every major U.S. carrier offering a co-branded credit card. While airline card programs have looked to capitalize on international travel and U.S. affluent growth, they are also tasked with responding to calls for increased rewards transparency, flexibility and simplicity.

Calls for change

In this regard, card issuer Capital One has influenced considerable market change by strongly promoting rewards transparency, flexibility and simplicity while offering a relatively rich set of rewards and benefits—and changing consumer expectations in the bargain. With its Venture travel credit cards, it has applied this philosophy to higher-end airline cards: On these cards, miles earned come with no blackout dates or restrictions, no miles expirations, and no foreign transaction fees—card benefits that have challenged airline co-brand programs to respond.

Southwest Airlines responds

Of course, Southwest has always been more of a discount airline, and outside of Mexican and Caribbean routes inherited from its merger with AirTran, it does not have an international presence—factors that help make the airline an ideal candidate for a rewards program that promotes transparency, flexibility and simplicity.

A cure for own-branded travel cards

By launching its Rapid Rewards frequent flyer program in March 2011, that's just what Southwest Airlines did, by employing a co-brand strategy that can go head to head with non-co-branded travel rewards programs by offering consumers a high value, high transparency rewards program while offering new tweaks to benefit card partners.

Setting the transparency bar

Under the current program, members earn points for every dollar spent, whereas, under the prior program members earned credits for flight segments flown. The amount of points earned is based on the fare and fare class purchased, with higher fare products (e.g., Business Select) earning more points than lower fare products (e.g., Wanna Get Away). The same rationale applies to redemption.

The three credit card cards under the Southwest program (Southwest Airlines Rapid Rewards Premier, Southwest Airlines Rapid Rewards Plus and Southwest Airlines Rapid Rewards Premier Business Card) still allow cardholders to accrue points based on card spend using common conversions (2 points per dollar on Southwest Airlines and AirTran Airways purchases made directly with the airlines and on hotel and car rental partners; 1 point per dollar on everything else). However, when using the Southwest website to book fares, customers (both cardholders and non-cardholders) are given the option to price the fare in dollars or points.

The number of points required to redeem for a flight is based on which fare is purchased:

Fare Product	Number of Points per Dollar to Redeem
Business Select	120
Anytime	100
Wanna Get Away	60

Other benefits

The process is not only very straightforward and transparent, but it also removes challenges otherwise posed by seat restrictions or blackout dates (there aren't any). By simplifying the process of applying rewards to airfare (and advertising the ability to do so every time a cardholder wishes to book a flight on the site), it promotes using rewards. For credit card holders who prefer straightforward use of miles—instead of ancillary soft card benefits, may greatly appreciate this approach.

It also incentivizes the use of the company website to book flights—why go to a travel booking sites such as Expedia and Travelocity to book your flight when you can so readily use your card rewards on Southwest's site? While Southwest does not participate in travel booking sites such as Expedia and Travelocity, airlines looking for way to build traffic to their own site could also benefit from this approach. Showing the process so transparently to non-cardholders using the site also promotes the card.

The upside for consumers is that "Wanna Get Away" conversions from points to airfare dollars exceed the initial 1-to-1 conversion from dollars to points on "everything else" purchases, and "Anytime" purchases provide an equal reconversion opportunity, which customers likely view favorably from the standpoint of perceived fairness and value of the rewards.

As for points earned, they do not expire so long as the Rapid Rewards Member has points-earning activity during a 24-month time period. Members also continue to accumulate points until the time they decide to redeem them, instead of automatically receiving certificates when their accounts reach a certain threshold. This allows them to earn and redeem points when it suits them best, and at market prices.

The program also enhances frequent flyer perks, including "Fly By" priority check-in and security lane access, where available, as well as dedicated phone lines, standby priority, and an earnings bonus on eligible revenue flights, receipt of the best boarding pass number available, and companion passes.

Results

For Southwest, the results have been quite positive, meeting or exceeding its goals, including:

- Bringing in new customers, including new Rapid Rewards Members and new co-branded cardholders
- Increasing business from existing customers
- Strengthening the company's Rapid Rewards hotel, rental car, credit card, and retail partnerships.

NICHE GROWTH CASE STUDY: AMERICAN EXPRESS & MERCEDES BENZ/MORGAN STANLEY

With so many co-brand programs already targeting the affluent, issuers must pick and choose especially wisely in their quest to reach this demographic.

No stranger to co-branding

No stranger to affluent cobranding, American Express offers at least 19 different co-branded credit cards: On the consumer side, it offers 13 co-branded cards, while on the small business side it offers six. By card association/network brand, we estimate that American Express has the highest ratio of co-brand/affinity card users to standard (non-co-branded) card users: with 73 such users for every 100 standard card users.

Heavily reliant on airlines

American Express is also heavily reliant on airlines (which we estimate generated roughly $55 billion in U.S. purchase volume for the company in 2012). In addition to airline partnerships with Del Air Lines, JetBlue and Virgin Atlantic cards, it maintains a solid presence in the hotel space via its Starwood and Hilton partnerships.

But while its Lowe's and Costco relationships give it a retail foothold, it's a relatively small one: American Express has only two of the 71 retail co-brand partnerships we counted as part of our segmentation study.

Niche strategy with a payoff

But by adding Mercedes Benz and Morgan Stanley to its stable of partners, American Express kills a few birds with one stone:

- Continuing to court affluent customers
- Building its retail co-brand presence
- Widening the field of its partner markets to financial services
- Opening up new distribution channels

With its Mercedes Benz and Morgan Stanley partnerships, minted in 2012, American Express continues to grow its affluent cardholder base. Each new partnership is associated with two cards. Along with the co-brand credit card, each company also offers a platinum charge card.

- The Morgan Stanley Credit Card from American Express and The Platinum Card from American Express exclusively for Morgan Stanley.
- The Mercedes-Benz Credit Card from American Express and The Platinum Card from American Express exclusively for Mercedes-Benz.

But in a twist on partnerships launched so far in the U.S., Mercedes-Benz and Morgan Stanley integrated the American Express cards into their own distribution channels, allowing it to leverage Mercedes dealerships and Morgan Stanley financial advisor client relationships for distribution and customer acquisition.

RETAIL STRATEGIES

TARGET EMPHASIZES PRIVATE LABEL AND DEBIT

As for the middle-income consumer, one need look no further than Target to find that some retail card programs that rely on the middle class already perform quite well. But by no longer opening new Visa-branded credit card accounts, Target is placing additional emphasis on its private label credit card and co-branded debit card to capture customer spend.

Although Target sold its credit card portfolio to TD Bank during Q1 2013, its REDcard card platform continues to play a prominent role for the company. With the purchase, TD gains more than five million active Visa and private-label accounts and inherits a gross outstandings balance of $5.8 billion. The bank is now the exclusive issuer of Target-branded Visa and private label consumer credit cards to Target's U.S. customers.

Target-branded credit cards ring up $5.8 billion in-house

In 2012, some $5.81 billion (or 7.9% of Target's retail sales) were charged to Target-branded credit cards, up 23.9% from 2011, on top of 35.6% growth in 2010.

Private label taking more prominent role

On- and off-premises gross charge volume reached $11 billion in 2012, but was growth strongly skewed toward on-premise volume, in part because the company no longer opens new Target Visa credit card accounts.

Co-brand debit opportunity

However, the Target Debit Card (still issued by Target, not TD Bank), has quickly caught on, responsible for $4.2 billion (or 5.7%) of Target's retail sales in 2012, up 137% during 2011-2012. Going into 2013, Target debit cards were issued at an estimated 2-to-1 rate in comparison to credit cards, suggesting strong demand among customers.

Program differentiation

The REDcard is very straightforward, offering an everyday discount of 5% on all eligible purchases, a key factor making it stand out from other retail credit cards. The discount applies not only to its co-brand credit card but also to its private label credit card and debit card.

Everyday discounts emphasized

Rather than earning points and redeeming them with future purchases, the card offers an immediate and easy-to-understand flat rate discount. From a consumer standpoint, the card is remarkably easy to use and understand. The sophistication in Target's program happens in the background, through data analytics and tailored offers that increase visits and average customer spend.

While no store-wide loyalty program is associated with the card, the company does automatically sign card users up for the Target Pharmacy Rewards program, in which customers receive a 5% off a day of shopping after filling and paying for 5 prescriptions at Target Pharmacy. The company also has a robust data analytics program that identifies opportunities to incentivize customer spend by offering tailored discounts to consumers via email and print mailers. Target tracks the purchase history of consumers, and prompts store employees to offer REDcard at the point of sale to desirable customers.

Revenue and profit contribution

In 2012, the year before Target sold the portfolio to TD Bank, its credit card segment contributed 10% to U.S. profit in 2012, roughly the same percentage it contributed in 2010. More than 80% of credit card portfolio revenue came from finance charges, although it also collected $79 million in merchant fees in 2012, thanks to fees generated every time cardholders use its cards outside of Target.

MACY'S BLENDS CACHE, A TIERED CARD PLATFORM AND REWARDS WITH SIGNUP DISCOUNT

With its Macy's American Express and Macy's Preferred American Express Cards, Macy's goes a different route: for those wishing to upgrade from a Macy's private label credit card, these co-branded credit cards emphasize cache, a tiered card platform and rewards as well as a strong up-front signup discount.

Both the Macy's American Express and Macy's Preferred American Express cards are very similar in the benefits and terms offered. Both cards offer a sign-up bonus of 15% off all purchases made on the day the account is opened—among the highest sign-up bonus offers seen. Account holders for both cards are automatically enrolled in the Star Rewards program and are offered a variety of shopping incentives throughout the year, including Star Reward Passes for dollar amount or percent discounts, and card holder sale events throughout the year.

Rewards

Macy's Preferred American Express offers a few additional benefits. First, there is a traditional rewards component with this card. Purchases at Macy's earn 3% back in rewards, and all other purchases earn 1% back in rewards. Once a card holder has accumulated $25 in rewards, Macy's issues a $25 Star Rewards certificate to use for a future purchase at the store. In addition, account holders for the card get access to a variety of travel privileges through American Express.

Target audience

The opaque nature of most of the regular benefits on offer with these cards (i.e. there is no set schedule for the issue of Star Rewards Passes for discount promotions) indicate that the store is seeking to target a demographic more concerned with the experience and prestige of the card rather than the specific financial benefits. The Macy's Preferred American Express card (and, to a lesser extent, the Macy's American Express card) reserve the majority of benefits for those who spend significant amounts of money at the store. Macy's has a premium image, and they are clearly targeting a premium demographic for this card, hoping that brand loyalty will increase with the soft benefits offered.

CONCLUSION

Innovation—including rewards, soft benefits, and rewards/program transparency—will drive the market for co-branded credit cards forward. With the macroeconomic ingredients in place, the future looks bright, and we see co-branded cards playing an important role in engaging a wider range of consumers and driving their spending.